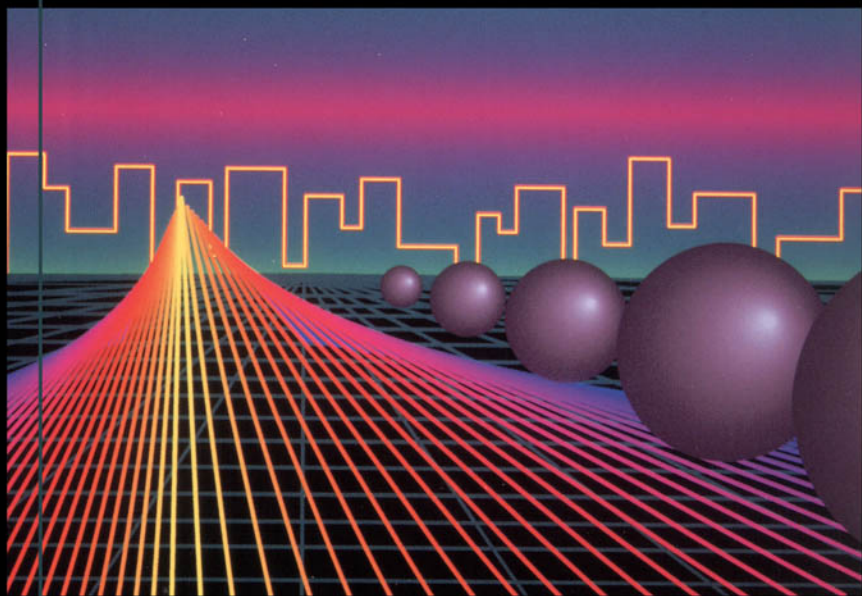


# Real Estate Investment Trusts

STRUCTURE, PERFORMANCE,  
AND INVESTMENT OPPORTUNITIES



SU HAN CHAN  
JOHN ERICKSON  
KO WANG

Financial Management Association Survey and Synthesis Series

OXFORD UNIVERSITY PRESS

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To our parents, with love and gratitude.

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## Preface

A recent survey conducted by the National Association of Realtors indicates that more than half of the household wealth in the United States is in real estate. This has been the case even in the late 1990s and early 2000s, when Internet business has attracted the attention (and financial resources) of most investors. Surveys ranking the richest people in the world always report that a majority of them have wealth tied to real estate or are in real estate-related businesses. In sum, regardless of the wealth level of an individual, real estate is one of the most important assets—if not *the* most important asset—for any investor.

Ironically, despite its dominant position in most investors' portfolios, real estate is probably the subject that receives the least attention among finance scholars and in the investment community. For example, although there are several academic journals devoted to the study of real estate, top-tier mainstream finance journals rarely publish real estate-related research. Moreover, when compared to industrial firms, the real estate sector has not received as much attention from the financial analysts of major investment firms. This lack of attention may be due to the difficulty of gathering information on real estate markets.

Possibly because of this lack of attention from the investment community, both the public and private real estate markets traditionally have been viewed as being less efficient than the general stock market. However, given the important role real estate plays in our economy, we believe in making an effort to enhance the understanding of the general investing public about real estate markets. Acting on this belief, we decided to write a book that draws on our own research in real estate markets over the years

and on the works of other respected professionals and scholars in the real estate field. Specifically, we concentrate our effort on the *real estate investment trust (REIT)* market, which is considered to be the most transparent among all real estate markets.

Most existing REIT books are written in a way that provides narrowly focused technical knowledge on how to conduct business in REITs. Some books survey the REIT literature, but in a fragmented manner. Our book has a different objective. We convey important lessons that real estate and finance academics have learned about REITs to both the general public and real estate practitioners, including REIT managers and advisors. We survey the academic literature on REITs and synthesize the findings in a way that is *both understandable and useful to academicians and general investors alike*. We provide not only explanations of various problems REITs have had over the years, but also the solutions that managers and lawmakers have developed to make the REIT a more effective vehicle for managing real estate assets. We provide our own insights into the structure and performance of REITs to inform the reader about their future development. Finally, we illustrate many of the issues we discuss with data from our own unique, comprehensive database, which tracks the changes in organizational form and REIT stock performance since information on the earliest REITs first became available in 1962.

We hope that, by providing this comprehensive examination of the industry, our book will energize the investment community's interest in REITs and provide useful information to the policy- and lawmakers who enact regulations governing REITs. We also hope that, by highlighting the problems and improvements associated with past REITs, REIT executives will be able to manage their trusts more efficiently and transparently so that this market will become an important vehicle for investing in real estate. Finally, it is our hope that this book will stimulate students' interest in the subject matter and provide a solid foundation for our colleagues to conduct additional quality research on real estate markets.

## Acknowledgments

We wish to express our sincere appreciation to those who have given constructive comments and suggestions for the book. Specifically, we are indebted to the 12 individuals who have devoted a significant amount of their time to review the draft of each chapter of the book. Those individuals are Brent Ambrose (University of Kentucky), Dennis Capozza (University of Michigan), David Downs (University of Georgia), Robert Edelstein (University of California–Berkeley), George Gau (University of Texas–Austin), John Glascock (George Washington University), Joseph Gyourko (University of Pennsylvania), Youguo Liang (Prudential Real Estate Investors), David Ling (University of Florida), Jianping Mei (New York University), Glenn Mueller (Johns Hopkins University and Legg Mason), and Kerry Vandell (University of Wisconsin–Madison). Their comments greatly improved the quality of the book.

We also would like to thank Paul Donnelly, Kenneth Eades, Arthur Keown, and John Martin for their encouragement and assistance. Their guidance made it possible for us to write this book for the Financial Management Association and Oxford University Press Survey and Synthesis Series. This book could not have been completed without the support of our universities. In this regard, we express our special thanks to Kam-hon Lee (former dean of the Faculty of Business Administration at the Chinese University of Hong Kong), Anil Puri (dean of the College of Business and Economics at the California State University–Fullerton), and Richard Wong (director of the School of Business at the University of Hong Kong).

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## Real Estate Investment Trusts

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# 1

## Introduction

### ***Is a REIT a Stock or Real Estate?***

A traditional *real estate investment trust (REIT)* is essentially a closed-end fund created exclusively for holding real properties, mortgage-related assets, or both. This investment vehicle was created by the U.S. Congress in 1960 for the express purpose of providing investors with an opportunity to invest in real properties and, at the same time, to enjoy the same benefits provided to shareholders in investment trusts. In order to make REITs a more attractive investment, Congress waived the corporate-level income tax on REITs if they met the conditions set by tax laws governing them. Among the conditions are that REITs must be widely held and that they must distribute most of their taxable income as dividends to shareholders.

Before the creation of REITs, investors could purchase real properties only from the property market (and not from the stock market). However, with the creation of REITs, it is possible to trade properties in the stock market since they are now in a form of a corporation or trust. In other words, investors can buy REIT stocks from the stock market with the intention of buying a pool of real properties and/or mortgages. Thus, the REIT concept made it possible and convenient for small investors to invest in real estate.

In recent years, the changes in tax laws have allowed REITs to manage their own properties and provide related services to their tenants. In this regard, some of the modern REITs can also be viewed as operating companies (rather than as pure closed-end funds, like traditional REITs). However, even for the modern REITs, real estate holdings are still the most significant part of their assets. Given this, it is fair to say that most REITs (traditional or modern) can be viewed as pools of properties (and/or mort-

gages) traded in the stock market. REIT investors need to understand both the property market and the stock markets in order to make sound investment decisions. Although some investors have substantial experience investing in the real property market and others might understand the stock market quite well, only a few are proficient at investing in both markets.

There are, in fact, quite a few differences between the property market and the stock market. On the surface, we see that the pattern of price movements in the stock market is significantly different from that in the real estate market. For example, we know that the price of a stock can change every minute, while the price of real property does not change quite so fast. We frequently observe that the prices of REIT stocks move significantly within a day while the prices of the underlying properties stay the same.

We can use an extreme case to illustrate this situation. We know that the stock prices of REITs dropped more than 20% on what is now called Black Monday in October 1987. However, the price of the underlying properties did not drop on that day. Although the price of a REIT is supposed to reflect its underlying property value, the prices of REITs either before or after Black Monday did not reflect their underlying property values. (It is also possible that neither prices reflected the underlying property values of REITs.) In any case, from this particular example, we know that a REIT's stock price might differ significantly from its underlying property value, at least in the short run.

While we cannot—and will never—know which REIT price (before or after Black Monday) tells us more about the underlying value of the property, we might wonder why few investors arbitrated the profits. For example, if the investors believe that the price of the REIT stock has dropped far below its underlying property value, they should, in theory, buy up all the REIT's stocks (or enough shares to control the REIT), disband the REIT, and sell off its properties in the property market. Indeed, if managers of REITs believe that REIT stock prices are valued far below the value of their underlying properties, they should sell all the properties and give the money to their stockholders. It seems that, depending on the market conditions, smart investors should move between the property market and the REIT stock market to arbitrage the profits.<sup>1</sup>

Obviously, besides transaction costs, there must be some structural issues associated with the organization of REITs that prohibit investors from arbitraging profits between the two markets. For example, REIT managers and the advisors of a REIT might be able to control the important corporate decisions regarding the REIT, making it difficult for outsiders to intervene in management decisions. It is also possible that the price information on the underlying properties or mortgages might not be readily available. This is especially true for some mortgage REITs with special provisions on income or appreciation participation. (That is, the owners of mortgages may receive not only debt service but also income from properties based on certain conditions.)

The problems of valuation uncertainty and the lack of understanding about the actual value of the underlying properties can be amplified by the nature of the REIT. Congress enacted laws governing REITs with the intention of creating an investment vehicle for small investors to invest in real estate. In fact, the tax law governing REITs specifically limited the number of large investors a REIT could have and also encouraged diversified REIT ownership. However, without help from sophisticated institutional investors, it would be difficult for small investors to analyze the REIT market on their own. (Of course, this observation applies to most stocks in the market.)

The complicated valuation issues inherent in REITs together with their unique fund-type organizational structure, the constraints on corporate policies imposed by tax regulations, and their diversified ownership structures make REITs a unique group of stocks in the stock market. In fact, several researchers in the field of finance (especially those studying initial public offerings, or IPOs) specifically exclude REITs from their samples when they seek to analyze special phenomena in the stock market. It is clear that the stock market does not understand REITs to the extent that it should.

Over the past 40 years, the REIT stock market experienced several ups and downs—but it has also experienced unprecedented growth. Prior to 1986, total REIT capitalization stayed well below \$10 billion even though REITs had been in existence for 25 years by that time. At one recent point, it was estimated that the equity market capitalization of REITs was close to \$160 billion.

This explosive growth suggests that experience has taught investors lessons on how to evaluate REIT stocks. Regulators and REIT managers have also learned from past mistakes and are striving to revise the REIT structure to serve investors better. However, all the evidence on REIT valuation and performance and the lessons that investors and REIT managers have learned are currently documented only in a piecemeal fashion. There is a need to summarize past experience and to synthesize the evidence about REIT investments in a systematic way to provide guidance for the future development of the REIT market. This book aims to fulfill this need.

## Why REITs Deserve Our Attention

Although we do not know the exact amount of real estate wealth in the world, we can safely conclude that real estate comprises a significant portion of the world's wealth. The consensus is that real estate comprises 40–50% of the total wealth in the United States.<sup>2</sup> Most U.S. families own their own homes, but the majority of commercial properties are still in the hands of investors. What would happen if most of the commercial properties were traded (via REITs) in the stock market? Is there any reason to believe that this will not happen?

We know that the values of many large commercial properties are higher than the values of many of the companies traded in the stock market. If companies with small capitalizations can be traded in the stock market, then so should properties with large capitalizations. Indeed, we see no reason that properties should not be traded in the stock market just as companies are. As the size of the REIT market increases, it will be important for us to understand this market much better than we do currently.

### Increasing REIT IPO Activities

Will some of the commercial properties currently available be securitized and traded in the stock market? The answer is probably yes. How quickly the process of the securitization will move is another question. Given the size of the real property market, it will take a long time for the stock market to securitize even a small portion of the properties in the real estate market. From the existing evidence on real estate securitization, we believe that there is momentum for this activity.

Table 1.1 reports the funds raised through the IPO activities of REITs and by non-REIT firms from 1970 to the end of October 2001. One can see that, as a single industry, REITs contribute a significant portion to the IPO pool. During the 1970–2000 period, the total funds raised from REIT IPOs was about 7.57% of the total funds raised by IPOs in all other industries. This percentage exceeded 20% in 4 of the 30 years under investigation. This is, indeed, a very significant percentage for a single industry.

This percentage is also steadily increasing. Between 1970 and 1979, the percentage was 7.02, but it grows to 9.08% during the 1990–99 period. Although REIT IPO activity is quite cyclical (e.g., there are many IPOs in 1993–94 and 1997 but none in 2000–01 [as of October 31]), there is no reason to believe that in the long run the increasing trend of real estate securitization will slow down. As REITs continue to move into the market, it will become even more important for investors and REIT managers to have a better understanding of them.

### REITs Are Different from Other Stocks

One might ask why it is necessary to study the literature on REITs. Couldn't we simply study the finance literature that covers all stocks in the market to gain an understanding of REITs? After all, REITs are part of the general stock market, are they not? Although REITs are traded in the general stock market, they have not been treated as general stocks by researchers. As mentioned earlier, many finance researchers specifically exclude REITs in their samples because they believe that REITs behave differently from other operating companies in the general market.

More important, many studies have found that REITs either behave differently from other types of stock in the market or have certain unique

**Table 1.1 Comparison of Equity Funds Raised through Initial Public Offerings by REITs and by Non-REIT Firms**

Year End	Funds (in \$ millions) Raised from IPOs		Funds Raised by REIT IPOs Relative to Funds Raised by Non-REIT IPOs (%)
	By REITs	By Non-REIT Firms	
1970	61	780	7.82
1971	182	1,655	10.98
1972	170	2,724	6.24
1973	59	330	18.02
1974	0	51	0.00
1975	0	264	0.00
1976	0	237	0.00
1977	0	151	0.00
1978	0	247	0.00
1979	10	429	2.40
1980	30	1,404	2.14
1981	50	3,200	1.56
1982	215	1,334	16.12
1983	68	13,168	0.51
1984	237	3,932	6.04
1985	2,706	10,450	25.89
1986	905	17,571	5.15
1987	539	13,841	3.89
1988	964	4,514	21.35
1989	500	5,721	8.74
1990	350	4,749	7.37
1991	208	16,202	1.28
1992	878	22,989	3.82
1993	8,469	30,587	27.69
1994	6,614	19,039	34.74
1995	923	29,422	3.14
1996	1,133	43,150	2.63
1997	6,216	34,010	18.28
1998	2,236	35,052	6.38
1999	292	65,653	0.44
2000	0	66,480	0.00
2001 <sup>a</sup>	0	n.a.	n.a.
1970-79	482	6,868	7.02
1980-89	6,213	75,135	8.27
1990-99	27,319	300,853	9.08
1970-2000	34,015	449,336	7.57

*Source:* For REITs, the data are based on the authors' REIT sample and various publications by NAREIT. For non-REIT firms, the data are based on an updated version (as of April 16, 2001) of Ibbotson, Sindelar, and Ritter's (1994) table and are available on Jay Ritter's Web site, <http://bear.cba.ufl.edu/ritter>.

<sup>a</sup>Data are as of October 31, 2001.

characteristics (or factors) that other stocks do not share. These studies examine topics such as return prediction, price-generating processes, dividend policies, capital structure, initial and seasoned public offerings, and merger activities. Indeed, given REITs' unique trust structure and tax regulations, it would be surprising if they behaved exactly the same as other stocks. The uniqueness of REITs underscores the need for a synthesis of existing REIT studies to better understand them. In other words, if a student of the market simply applied his or her knowledge gained from the general stock market to that for REIT stocks, this student might be in for a surprise.

### Bringing the Evidence Together

Virtually all currently available books on REITs either address the REIT industry solely from the perspective of the investor in REIT stocks or present advice on how to organize a REIT from the perspective of a future REIT operator. Some books on the subject are compiled from individual articles on REITs without providing an integrative discussion of the issues surrounding them. Not many texts in the market present what is currently known about REITs in a comprehensive, organized, and documented fashion.<sup>3</sup> Furthermore, no books before now have used detailed, up-to-date data to describe the REIT industry.

In addition, individual knowledge of the REIT industry that is based on limited observations and ad hoc information is useful, but will not by itself provide a comprehensive understanding of the many complicated issues surrounding REITs. The industry can best be understood through an analysis of the empirical evidence provided by existing academic research on REITs. Our purpose in this book is to analyze the REIT market in a systematic manner by synthesizing the extensive evidence derived from academic research with relevant views expressed by finance and real estate practitioners in the popular press.

### Survey and Synthesis of Evidence

This book is designed to serve as a bridge connecting practitioners in the REIT field with researchers in real estate and finance. There is currently a large body of finance and real estate literature (more than 400 academic and practitioner articles) examining the characteristics of REITs in a rigorous and scientific manner. This literature addresses issues that are of particular interest to the real estate and general investor communities. For the most part, the literature on REITs is not well known outside academic real estate and finance circles. But it does provide important information for investors and managers by documenting the characteristics of REITs that are responsible for the phenomenal growth of the industry. This book syn-

thesizes this large body of literature in a systematic and comprehensive way to provide useful information to investors, REIT managers, academics, and students who are interested in learning more about REITs.

### A Comprehensive Database

The most serious problem researchers face when summarizing results from academic studies is the lack of synchronization of sample periods used in those studies, which makes the comparison of their results difficult. In addition, few published empirical studies in the academic literature use the most recent data available (which, in those studies' defense, could partially be due the fact that it takes a long time to publish an academic study). To minimize these two problems, we have established a large and up-to-date database on REITs created over the last 10 years. Where necessary, we use the most recent data from this database to replicate and update some of the results reported in other studies. By so doing, we have the most up-to-date information available for our discussions.

The database we use in this book is very large; it includes information on the publicly traded REITs presently in existence, as well as information on the REITs that have not survived during the past 40 years. This means that, other than the National Association of Real Estate Investment Trusts (NAREIT), we have the largest database on REITs we know of, comprising a total of 486 REITs that have trading information between 1962 and 2000. In addition, with our database, we eliminate the survivorship bias that can distort discussions of the issues surrounding REITs (especially on REIT stock performance). As a side benefit, we also used this database to generate a comprehensive return index for the REIT industry; it is included in the appendix. This index will give the reader a useful and quick reference on the return performance of REITs over the 1962–2000 period. Our analyses required the use of a massive amount of stock return and firm performance data, which are available only from the Center for Research in Security Prices (CRSP) and COMPUSTAT tapes. Because CRSP updates its data once a year, the data available in the tape as of October 2001 goes only up to 2000. Thus, our analysis covers the period from 1962 to 2000.

### Issues of Interest

Our intention is to provide a thorough analysis and synthesis of the existing research on REITs in a way that will enable managers to improve their investment decisions and the REITs' operating performance. Our analysis is designed to give practitioners a more thorough understanding of the changes in the industry that have affected REIT operating performance in the past as well as the factors that can be expected to affect their perfor-

mance in the future. With this in mind, we will focus only on issues that are relevant to managing and investing in REITs. We first identify the important issues that we believe deserve our attention; we then classify them into three categories: understanding REITs, managing REITs, and investing in REITs.

### Understanding REITs

Before we can analyze REITs in detail we have to understand the basic structure of the REIT market—how it evolved and the reasons for its past failures and successes. To accomplish this, we focus on the following seven issues.

- Do REIT stocks resemble non-REIT stocks in the general market?
- Should we view REITs as stocks or property?
- Does the REIT organizational form reduce the cost of capital for real estate companies relative to that of traditional real estate operating companies?
- Is the performance of REIT stocks different from the performance of the stocks of master limited partnerships (MLPs) or commingled real estate funds (CREFs)?
- What is the effect of institutional investor participation on REIT performance?
- How does the number of financial analysts following REIT stocks affect REIT stock performance?
- How efficient is the market for REIT stocks in providing liquidity, information dissemination, and price determination?

### Managing REITs

Both traditional REITs (similar to closed-end mutual funds) and modern REITs (similar to operating companies) are governed by special tax laws. Although these laws provide significant tax benefits on the corporate income tax level, they also require that REITs pay out a significant portion of their earnings. This requirement has put a constraint on REIT financial policies. There are at least eight important issues surrounding the financing of REITs that deserve the attention of REIT managers. These issues are as follows:

- How do REIT financial policies, such as policies on dividend and capital structure, affect their performance?
- How does REIT market capitalization affect performance?
- How do property acquisitions and dispositions affect the market value of REITs?
- What is the impact of REIT merger and acquisition decisions on share values?

- How do agency issues (potential conflicts of interest among shareholders, managers, and creditors) affect shareholder wealth?
- What is the trend in institutional investments in REITs, and what are the implications of such investments on the agency and on corporate control issues prevailing in the REIT stock market?
- When and why do REITs make secondary offerings?
- Should REITs pay more dividends than is required by the tax laws?

## Investing in REITs

We will examine the characteristics of the various types of REIT stocks and document the factors that affect their performance. This book will also add to the existing literature on the subject by providing an analysis and synthesis of REIT performance as influenced by organizational structure, asset type, management style, and the financial policies of REITs. Ten issues are important to REIT investors. They are the following:

- Which type of REIT stock has performed the best, and which type can be expected to show superior performance in the future?
- Does investing in a number of different REITs with alternative asset holdings improve diversification and stock performance?
- How can REITs play an essential diversification role under classic portfolio theory?
- What are the top performing sectors of the equity REIT industry?
- To what extent is the market for REITs efficient?
- Is the potential conflict of interest between the managers and the shareholders of REITs really a problem for shareholders?
- Do REIT stocks provide more diversification for investment portfolios than direct investments in real estate or investments in private pooled real estate vehicles, such as CREFs?
- Do the recent changes in REIT organizational structure affect REIT performance?
- Can we predict REIT returns? If we can, how?
- How do REIT IPOs perform in the short run and in the long run?

## Where We Are Headed

To begin our analysis, in chapter 2 we first review the evolution of the REIT concept. From our discussion of the ups and downs of REITs, we are able to identify the problems they face and to see whether the solutions to those problems have been effective. This chapter will provide us with basic information for the analysis in later chapters. We then move, in chapter 3, to a discussion of the organizational structure of REITs. We pay special attention to the recent changes in REIT structure and the issues related to their optimal structure. The creation of the operating format for REITs might change the way REITs perform in the stock market.

Chapter 4 is devoted to a unique issue faced by REITs. Similar to a stock mutual fund that needs a fund manager, a REIT also needs an advisor or manager for its day-to-day operations. The use of an advisor has created a great deal of controversy in the REIT industry. We tell you why and offer potential solutions. There has also been much debate recently in the REIT industry on the optimal size of a REIT. Should a REIT be as big as possible? Chapter 5 will give you the answer.

We believe that one of the most important changes in the REIT industry during the past 40 years is the increasing presence of institutional investors in the REIT stock market. REITs were originally designed to be an investment vehicle for small investors. We know, however, that small investors lack bargaining power. In chapter 6, we discuss the problems of having small investors and the changes institutional investors have brought to the REIT industry. Chapter 7 addresses another timely issue: Should a REIT concentrate its investments in one property type and/or in a small geographical area? Although there is no absolute answer to this question, there seem to be some commonly agreed upon principles, which we report in that chapter.

Chapter 8 discusses REIT dividend and financing policies. Because REITs are required to pay out high dividends and do not pay tax at the corporate level, the considerations of their dividend and financial policies must be different from those of industrial firms. In chapter 9 we discuss another unique characteristic of REITs: their IPOs. Empirical evidence tells us that REIT IPOs behave differently from industrial firm IPOs. We show the reader how they are different and review the factors causing the difference.

Chapter 10 offers focused and practical advice for readers who are interested in investing in REIT stocks. In that chapter, we examine the various issues related to the performance of REIT stocks. The issue of whether an investor can earn abnormal returns by predicting the stock movements of REITs is examined in chapter 11. Chapter 12 is our concluding chapter. We talk about the future directions of the REIT industry and the potential boom of REIT markets outside the United States, especially in Asia, and offer our opinions about the future of the REIT industry using our own crystal ball.

## **A Book for Wiser Decision Making**

Although the REIT concept dates back to the 19th century, the history known to investors is still relatively brief. However, the REIT industry has been expanding and has the potential to expand further. This rapid evolution has been driven, to a large extent, by tax changes—but it is also the result of innovations in organizational form that reflect the industry's desire to adapt to the needs of investors. The unprecedented growth in the number of REITs, their market capitalization, and institutional interest in re-

cent years suggest that managers have learned to avoid the types of problems that have plagued REITs in the past. In other words, managers may be wiser and investors may now be significantly more knowledgeable about the characteristics of REITs. This is the knowledge we would like to share with our readers. In addition, we believe that it is important for us to understand the problems facing REITs before we suggest how they can be overcome. Hence, we pay particular attention to the cause of a problem before we talk about the solution.

We have designed this book for the general reader and investor (large or small) interested in investing in REITs and for sophisticated REIT practitioners interested in learning more about their industry and its future directions. Because the book provides insights useful to REIT managers, it should also be of interest to consultants and lawyers who practice in the area of corporate law governing REITs or in real estate law, and to government regulators who work in the area of real estate securitization. Finally, the book will be of interest to finance and real estate students and the academic community alike.

## NOTES

1. We observe that several REITs took their companies private when the stock market conditions were poor. We can assume that part of the motivation was to arbitrage the profits between public and private real estate markets.

2. See, for example, Ibbotson and Siegel (1983) and Apgar (1986).

3. However, we like two books on REITs that we have read. One is by Block (1998) and discusses investing in REITs, and another is by Garrigan and Parsons (1998) and contains a collection of good articles on the subject.

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# 2

## The Origins and Evolution of Real Estate Investment Trusts

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### ***How Far Have We Come and Where Do We Go from Here?***

The REIT as we know it today is in fact the revival of an older idea in real estate investment, the roots of which lie in 19th-century New England. That idea—called the Massachusetts trust—had lain dormant for 25 years before investors revived its spirit in 1960. The REIT industry has gone through several ups and downs since then. Some of the downturns were caused by changes in the operating environment, such as changes in tax laws. Some of the problems, however, arose from the inexperience and greed of some past REIT managers and owners. Because of the lessons learned from these mistakes and the changes made as a result, the REIT environment is much more efficient today than when it was established in 1960. It remains far from perfect, however, and as we shall see, the REIT industry will have to keep evolving in order to survive in a changing environment.

### **The History of the REIT Concept**

The basic concept of the REIT originated with the business trusts that were formed in Boston, Massachusetts, in the mid-19th century, when the wealth created by the industrial revolution led to a demand for real estate investment opportunities. State laws at the time prevented a corporation from owning real estate unless the property was an integral part of the business. This made it impossible to use a corporation as a vehicle for investing and dealing exclusively in real estate. The *Massachusetts trust*, designed in re-

sponse to these laws, was the first type of legal entity allowed to invest in real estate. This entity provided benefits similar to those of a corporation: transferability of ownership shares, limited liability, and centralized management expertise.

The Massachusetts trust also offered another benefit that was crucial to its attractiveness as an investment vehicle: favorable tax treatment that eliminated federal taxation at the trust level and that allowed investors to receive distributions of rental income free of taxes at the individual level. Although originally formed to provide wealthy investors with a conduit for income from equity investments, the Massachusetts trust soon became available to general investors as well.<sup>1</sup>

After their success in Boston, the trusts began to provide capital to develop real estate in other cities such as Chicago, Omaha, and Denver. The Massachusetts real estate trust remained a conduit for real estate investment until 1935, when the U.S. Supreme Court's removal of its favorable tax status resulted in its demise along with that of many similar trusts.

By the 1940s, the remaining trusts were competing directly for capital with tax-favored regulated investment companies (closed-end mutual funds, created by the Investment Company Act of 1940) and with real estate syndicates. The concept of the Massachusetts trust form of real estate investment was revived in the 1950s when its advocates, including one of the remaining trusts—the Real Estate Trust of America—lobbied the federal government for tax treatment equal to that of investment companies created by the 1940 act.

These efforts were rewarded in 1960 when the tax law was amended to give real estate trusts tax treatment similar to that for closed-end mutual funds. This gave small investors an opportunity to invest in real estate through a vehicle that provided investment expertise at a reduced cost, reduced risk, and a significantly lower minimum initial investment. By the time the first REIT came on the market in 1961, the underlying concept had actually been around for more than 100 years.

### REITs in the 1960s–80s

The 1960 law originally defined a REIT as *an unincorporated association with multiple trustees as managers and having transferable shares of beneficial interest*. This definition intentionally patterned REITs after closed-end investment companies. Like these companies, REITs could issue shares to the public, and the value of those shares would vary above or below the net asset value of the REITs themselves.

The legislation creating REITs also placed significant restrictions on their operations and investments. In order to maintain their tax-favored status, a REIT was required to meet the following restrictions:

1. Pay out a minimum of 90% of its taxable income to its shareholders every year;
2. Have at least 100 shareholders with no more than 5 of these owning more than a combined 50% of the trust's outstanding shares (the "5/50 rule");
3. Be an *investor* in real estate, as opposed to a broker;
4. Derive at least 90% of its gross income from rent and interest income, gains on the sale of property or shares of other trusts, and other real estate sources;
5. Derive a minimum of 75% of its gross income from real property interests, gains on the sale of real property, and shares of other trusts and other real estate sources; and
6. Have at least 75% of total assets in real estate properties or mortgages, cash, and government securities.

Failure to meet any of these restrictions would either subject a REIT to disqualification for special tax-exempt treatment purposes or disqualify a portion of its earnings from tax-exempt treatment at the corporate level.

The asset and trading restrictions on REITs were designed to make them long-term investments, in contrast to real estate syndicates and real estate corporations. The profitability of the latter companies depends on their ability to manage their assets actively through continuous purchase and sale. However, because REITs were designed as passive investment vehicles, they were prohibited from actively turning over their properties or directly managing them. Instead, they were required to either employ property management firms or lease their properties.

Until recently, most REITs employed advisory firms to determine their management and investment policies. These advisors received a fee, typically a percentage of total assets, in return for their services. In most cases, the advisory firms were the original sponsors of the REITs. McMahan (1994) observes, moreover, that managers who worked for REIT advisory firms were unlikely to have any significant investment in the stocks of the REITs they managed. This created a potential conflict of interest within the early REIT structure because managerial decisions were not necessarily aligned with those of the shareholders.

Like their predecessors that were built on the Boston model, the early REITs initially invested in real property. Despite their predecessors' popularity, however, REITs did not catch on at first, in large part because of the stock market decline in May of 1962. In addition, investors and analysts were unfamiliar with REITs, and neither federal nor state laws had been developed to deal with them. Elliot (1965) reports that by 1965 there were approximately 65 REITs in existence, most of which had been created prior to the market downturn of 1962. Schulkin (1971) indicates that between 1963 and 1968, total capitalization grew slowly, with only a handful of new REITs raising more than \$10 million in their initial offerings.

REITs initially focused on traditional property investments financed primarily with equity, but toward the end of the 1960s the growth of earnings (cash flows) was becoming an increasingly important objective of their managers and shareholders. As a result, REITs began to rely more heavily on short-term borrowing as well as on their traditional sources of financing: long-term debt, convertible debt, and warrants. In addition, a significantly larger number of new REITs focused on mortgage lending rather than simply on direct property investments. Almost all REITs created between 1968 and 1970, in fact, were mortgage REITs.

### The 1960s: REITs Attract Investor Attention

As investment vehicles, REITs did not become popular until the late 1960s. Between 1968 and 1970, REIT assets more than quadrupled from an estimated \$1.0 billion to \$4.7 billion. Records of new issues between 1968 and 1970 indicate that the number of new REITs increased dramatically—from approximately 61 to 161.<sup>2</sup>

This growth in the number of REITs and in their assets was due to several factors. First, not only were capital markets becoming more comfortable with REIT securities, but changing credit conditions and the higher interest rates that prevailed in 1968–70 and 1973 created a significant shortage of funds for construction and development companies. During that period, banks, thrifts, and insurance companies could not directly engage in construction and development (C&D) lending activities because of regulations and statutory restrictions. This gave them an incentive to set up publicly funded REITs to engage in these activities.

In addition, banks, thrifts, and other traditional providers of mortgage loans and C&D credit faced restrictions on their ability to raise funds by paying higher rates on deposits. *Mortgage REITs*, which have at least 75% of their holdings in such direct financial assets as mortgages and short-term loans (compared to *equity REITs*, which invest at least 75% of their assets directly in real property) were in a position to take advantage of these changing conditions by financing the purchase or construction of real estate properties. That is, because their rates were not regulated, mortgage REITs were able to pay the higher interest rates necessary to finance riskier mortgage and C&D loans. As a result, many banks and a number of developers set up their own mortgage trusts to satisfy the demand for short-term and higher risk C&D loans. These banks also frequently acted as the advisors to their trusts. These activities in late 1960s and early 1970s marked the beginning of a period of significant growth in the REIT industry.

Analyzing data from 114 REITs obtained from the National Association of Real Estate Trusts (NAREIT) and from standard sources of financial information, Schulkin (1971) found that 45 REITs had invested primarily in C&D loans and that 60 had invested primarily in long-term equity property

investments. In addition, 55 of these REITs were advised by commercial banks, insurance companies, and financial conglomerates, whereas 13 were advised by mortgage bankers.

Although most of the REITs created during this period were of the mortgage and equity type, a third type also appeared. This was the *hybrid REIT*, which represented a mixture of the equity and mortgage REITs because it invested in both real estate property and mortgages. (Table 2.1 and figure 2.1 give an idea of the trends in the growth in average and total REIT capitalization.)

### The 1970s: Rough Times for REITs

Although REIT returns were respectable in the early years, a number of problems soon surfaced—especially for mortgage REITs specializing in (C&D) loans and the higher risk mortgage segments of the industry during the early 1970s. The boom in building that had accompanied the significant increase in REIT financing for these types of loans ended in the way that many real estate booms frequently end: through poor investment decisions and overbuilding.

By 1973, mortgage REITs that financed C&D and longer term loans for condominiums and apartments faced markets in which properties were in excess supply. At the same time, interest rates were rising along with construction costs (due primarily to rising inflation and a shortage of construction materials). Hines (1975) suggests that these conditions led to a significant number of mortgage defaults and builder bankruptcies.

This situation was due in part to competition among lenders, which had caused many REITs to finance questionable projects. In many cases, REIT managers were inexperienced in real estate investing, and very few of them understood the limitations of the REIT vehicle as a source of funding for real estate development. As a result, most new REITs were financing long-term mortgages using short-term sources of funding, such as commercial paper with maturities ranging from 30 to 60 days. The short maturity of their sources of financing forced them to borrow at increasing rates, putting a strain on profitability and, in many cases, creating negative spreads between the cost of funds and the return on REIT investments.

Furthermore, the investment advisors for many C&D lenders were banks, which often lacked expertise in real estate markets. Robertson (1975) reports that these problems, coupled with the inherent conflict of interest among banks, REITs, and REIT advisors, created pressure on these REITs to make loans of questionable quality. This conflict of interest was motivated—predictably—by the desire of banks and REIT advisors to earn fee income. Since advisor fees were based on the gross amounts of funds loaned, advisors had a strong incentive to push REITs to borrow so that they could make new loans.

**Table 2.1 Annual Equity-Market Capitalization and Return Performance of Publicly Traded REITs**

Year-End	Capitalization (\$ thousands)		Total Return		
	Mean	Total	Annual Mean (%)	Index	Number of REITs
1962	21,010	42,020	22.64	122.64	2
1963	20,637	41,274	-2.58	119.48	2
1964	21,073	63,219	26.27	150.87	3
1965	33,138	132,554	14.52	172.78	4
1966	26,993	107,974	-12.79	150.67	4
1967	32,926	164,631	25.57	189.20	5
1968	68,379	341,895	65.96	314.01	5
1969	64,702	711,717	9.12	342.66	11
1970	51,216	1,587,699	8.06	370.29	31
1971	62,575	3,253,912	29.45	479.36	52
1972	59,823	6,939,422	14.65	549.60	116
1973	37,290	5,034,176	-29.62	386.79	135
1974	11,912	1,548,590	-66.89	128.05	130
1975	13,239	1,628,377	21.70	155.84	123
1976	18,048	2,219,856	56.12	243.31	123
1977	20,399	2,407,057	36.12	331.19	118
1978	19,939	2,292,997	13.32	375.28	115
1979	25,499	2,804,876	43.69	539.25	110
1980	31,449	3,490,866	33.68	720.86	111
1981	32,113	3,050,707	7.61	775.73	95
1982	46,337	4,170,314	28.35	995.67	90
1983	58,615	4,982,276	32.80	1,322.21	85
1984	70,218	5,757,841	12.68	1,489.92	82
1985	74,824	8,006,183	13.33	1,688.54	107
1986	91,518	10,158,482	12.45	1,898.78	111
1987	79,941	9,832,693	-12.43	1,662.73	123
1988	89,918	11,149,880	10.41	1,835.78	124
1989	94,854	11,287,613	-7.46	1,698.81	119
1990	72,426	8,473,844	-24.40	1,284.26	117
1991	92,910	12,635,755	26.86	1,629.27	136
1992	111,969	15,563,732	12.66	1,835.50	139
1993	177,075	32,758,840	39.19	2,554.81	185
1994	194,138	44,457,700	2.66	2,622.68	229
1995	252,195	56,239,464	21.69	3,191.62	223
1996	409,898	83,209,306	37.30	4,382.24	203
1997	630,108	132,322,628	24.54	5,457.67	210
1998	635,573	138,554,856	-14.24	4,680.47	218
1999	611,895	128,498,029	-2.39	4,568.44	210
2000	725,714	140,062,860	15.96	5,297.44	193

*Source:* Information prepared by the authors using the REIT sample described in the appendix.

*Note:* The return index series is based on December 1961 = 100.